avisowealth

Four pillars of investment tax planning

Fully informing the tax strategy for your portfolio

You harnessed your spending to set aside savings, and researched the investments you deemed worthy of your hard-earned dollars. And now as you admire your accumulating wealth, a dark cloud lies ahead – *income tax*.

Yes, earning investment income and paying tax on it can sometimes feel like you're taking two steps forward, one step back. But taking a positive view, it's better to earn income and pay tax on it, than not to earn at all. Still, you don't have to leave yourself open to the full force of taxes.

Guided by a few simple principles, you can position your investments to optimally navigate toward your future spendable wealth.

DEFER – Making sense (cents?) of the time value of money

The later you pay tax, the longer that more of your money works for you. Secondly, given that inflation erodes the value of money over time, in effect it costs you less to use future dollars to pay tax than to use today's more valuable dollars.

An example in a non-registered account is that you don't pay tax while the market price of your holdings rises year-to-year, but instead pay on those capital gains the year you sell. Or with a registered retirement savings plan (RRSP), you get a current tax deduction when contributing, understanding you'll be taxed on the withdrawal – which you expect will be years or even decades ahead.

SHELTER – Keep your umbrella up, to keep tax erosion down

Beyond the initial deposit, an RRSP is also an ongoing tax shelter in that there is no tax on the income earned while inside the plan. However, the sheltering effect ends when money is withdrawn, at which time it is fully taxable.

Comparatively, a tax-free savings account (TFSA) is funded out of your after-tax money, has that same tax-sheltering while inside, and then has no tax on withdrawals.

PREFER –
It’s not just how much, but sometimes also ‘what’ you earn

Certain types of income are taxed more favourably than others. Taking money from your RRSP is, once more, fully taxable.

In a non-registered account, interest and foreign stock dividends are also both fully taxable. However, only half of realized capital gains are taxable, and dividends from the stock of a Canadian corporation can be at an even lower tax rate, especially for those in low to mid tax brackets.

SPLITTER –
Whose income is it?

Up to now, we’ve looked at the what and where of the income; ‘income splitting’ shifts the focus to who is earning it. Because we have a progressive tax system – imposing higher tax rates as your annual income rises – the household tax bill may be reduced if income is split with someone at a lower bracket.

That could be as simple as contributing to your RRSP on the expectation you’ll be at a lower bracket later, or another option is to use a spousal RRSP. With non-registered investments, spousal income splitting is not as straightforward, but still possible with informed planning and conscientious recordkeeping.

As you can see, there is a fair amount of overlap among these concepts. Even so, it’s important to clearly understand the distinctions between them, as sometimes trying to achieve one requires a concession with another. An effective advisor will help you evaluate the tradeoffs so that you can make good choices.

For more information, please consult your financial advisor and tax professional.

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